Special Report 2011/05

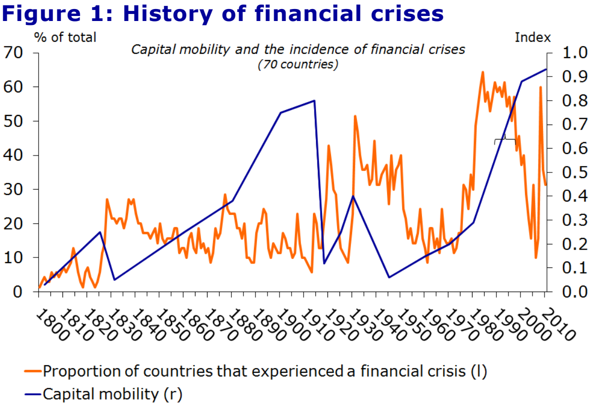
The history of financial crises

The world is littered with financial crises, yet we seem surprised every time they occur. Against this backdrop, we take a closer look at the financial crises since 1800 to see whether we can draw some lessons for the future.

The crises in the 19th century

Not a single year has gone by in the past two centuries where there was not a financial crisis somewhere in the world (see figure 1). Arguably, the world witnessed its first international financial **crisis in 1825** (Neal, 1998). The opening up of Latin America after the overthrow of the Spanish empire led to the opening up of international trade between England and the Latin American republics. The result was massive capital flows from London to finance infrastructure, mining and government spending. But once the capital outflows impinged on the Bank of England's (BoE) gold reserves, the policy rate was raised, leading to a banking crisis. A sudden stop of capital flow from London resulted in banking panics in the US and currency crashes across Latin America (Bordo and Landon-Lane, 2010).

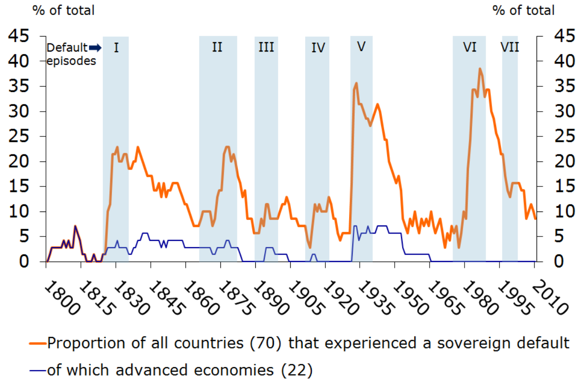
Figure 1: History of financial crises



Source: Reinhart (2010), Taylor (2004), Rabobank

Indeed, the crisis in 1825 marked the first of seven clusters of sovereign defaults in the period 1800 to 2010 (see figure 2), as identified by Sturzenegger and Zettelmeyer (2007). In the first cluster of defaults, which happened during 1824-1834, 13 Latin American countries defaulted. Other defaults involved Greece, Portugal, and Spain.

Figure 2: History of sovereign default



Source: Reinhart (2010), Rabobank

The following period (1835–1866) was relatively tranquil. But a lending boom developed in this period, which soon resulted in a new series of default episodes. The global **crisis of 1873** started with the collapse of a property boom in Germany and Austria, then spread through the continent and affected the US as European investors dumped US railroad stocks. The US had a major panic associated with a corporate governance scandal in the railroad sector (Benmelech and Bordo, 2008). Subsequently, the crisis spread to Latin America via a sudden stop of capital flows as the BoE raised its policy rate once again to offset gold outflows. This led to a series of debt defaults across the region. In the period 1867-1882 (the second cluster of defaults), 13 Latin American countries defaulted once again. Other defaults involved Austria, Spain, Turkey and Egypt.

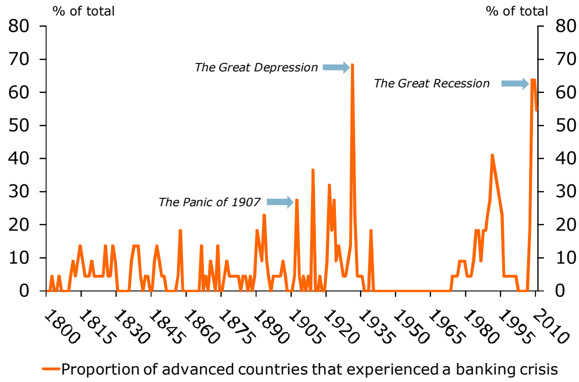
In the 1880s, the Western European countries started exporting capital to the Latin American countries for infrastructure investment. Major recipients of these funds were Argentina, Brazil and Uruguay. The associated land boom financed by generous bank lending conditions ended in a bust once more when the BoE and other European central banks began raising their policy rates to stem losses in their gold reserves. The sudden stop of capital flows led to banking crises in Latin America (Argentina, Brazil, Uruguay, Chile and Paraguay). This period also corresponds with the third cluster of defaults (1890-1900), whereby 12 Latin countries defaulted. Subsequently, the US, New Zealand, Portugal, Italy, Germany, and the UK experienced a banking crisis. It is also worth mentioning that Barings Brothers (a leading London merchant bank at the time), which was heavily exposed to Argentine debt, became insolvent.

The crises in the 20th century

As soon as we stepped foot into the 20th century, the advanced countries were hit by the **panic of 1907**, which started in the US after the stock market fell close to 40% from its peak (end-1906). As a result, banks in France, Italy, Denmark, Sweden, Japan, Canada and the US entered a crisis. Almost a decade later, the world witnessed another major financial crisis. The **crises at the end of WWI** reflected the attempts by central banks around the world to unwind the inflation that had built up during the War. Disinflation impinged upon the balance sheets of many European countries leading to banking crises in the Scandinavian countries, Switzerland, Spain, Portugal, the Netherlands, Italy, Japan and Mexico.

Then came the mother-of-all-financial-crises – **the Great Depression**. This episode was preceded by stock market booms that crashed in the US and UK in the late 1920s. A series of banking panics in the US beginning in October 1930 were not successfully allayed by the Federal Reserve and this turned the situation from bad to ugly. The depression was transmitted around the world by the fixed exchange rate links of the gold exchange standard and numerous protectionist measures. Many advanced countries (e.g. Australia, Austria, Belgium, Germany, Greece, Italy, Portugal, Spain, Scandinavian countries, Switzerland and the US) were finally hit by banking crises (see figure 3). Other countries that were affected were Argentina, Bulgaria, Poland, Romania and Turkey. The period 1931-1940 also marked the fifth cluster of defaults as 26 countries defaulted on their sovereign debt, of which 9 in Europe and 14 in Latin America.

Figure 3: History of banking crises



Source: Reinhart (2010), Rabobank

After WWII, the world economy entered a period of relative calm. This was primarily due to the Bretton Woods (BW) system. In this era, exchange rates were kept fixed, capital controls were widespread and financial regulation was strictly designed to prevent a reoccurrence of the financial chaos of the interwar period. We also need to stress that most developing countries had completely lost access to the international capital market after the War. As a consequence, there were very few financial crises until 1970. Once the BW system broke down in 1971, the global economy reopened and capital flows surged again. In specific, lending to developing countries exploded after the oil shock of 1973, which created the need for recycling the earnings of oil-producing countries. Against this backdrop, financial crises made an unfortunate comeback.

Banking crises erupted in both advanced and emerging countries in the 1970s. In 1974 in the US, Franklin National bank was bailed out while in Germany Herstatt bank was not. But neither of these events was considered to be a classic banking crisis. In the emerging countries there were scores of currency crises. By the end of the 1970s, the advanced countries shifted to a very tight monetary policy to break the back of inflation. Tight monetary policy and the ensuing recession in the West led many countries in Latin America and elsewhere to default on debts built up in the preceding inflationary era. Already in the late 1970s and the 1980s, we observed 33 sovereign defaults throughout the world, with half of them in the Latin American countries (17) and almost a third in Africa (10). The Latin American debt crisis triggered financial difficulties for banks in Canada, the UK and the US.

Eventually the defaulted bank loans in Latin America were restructured and a new lending boom started in the 1990s. Therefore, the last decade of the 20th century was full of crises. In the early part of the 1990s, Sweden and Finland experienced a property boom. The bust was triggered by the breakdown of the Soviet empire. These forces produced the **Nordic financial crisis**. Banks also failed in Norway. Other countries like Italy, the UK, Japan, Greece, and Australia also had banking crises in this period. Around the same time, the **European currency crisis** started after George Soros, a hedge fund manager, speculated against the sterling and forced the UK to exit the Exchange Rate Mechanism (ERM). Subsequently, a number of currencies in Europe came under attack by speculators (currency crises took place in Spain, Ireland, Finland, France, Italy and Sweden).

In 1994, the tight policy of the Fed triggered a massive devaluation by Mexico, which led to a banking crisis (**the Tequila crisis**). The contagion resulted in other Latin countries (Argentina, Brazil, Costa Rica and Dominican Republic) suffering from a banking crisis. In the second half of the 1990s, crisis made land-fall in the East. **The Asian Flu** started when the external debt-financed boom came to an abrupt halt amid mounting speculation against the Thai Baht in 1997. The devaluation of the baht increased pressure on the rest of the currencies in the region and finally resulted in currency and banking crises in Thailand, Indonesia, Korea as well as less dramatic disruption in Hong Kong, Malaysia, the Philippines and Taiwan. The Asian Flu had contagion effects on other emerging countries partly reflecting tighter lending conditions of Western banks. Two prominent countries were Russia which defaulted on its debt in 1998 and Brazil which had a serious currency crisis in the same year. The Russian crisis also managed to push Long-term Capital Management, an American hedge fund led by two Nobel laureates in economics, towards bankruptcy as it was greatly exposed to Russian debt.

The crises in the 21st century

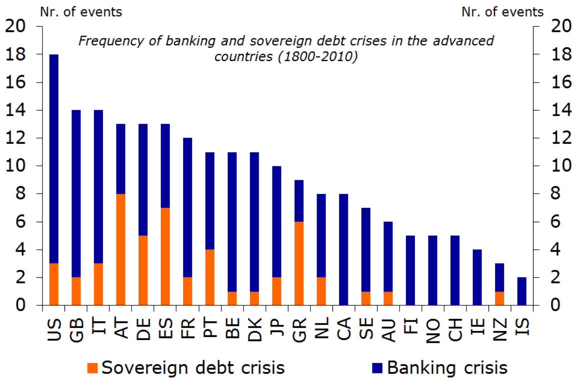
As soon as we entered the new millennium, Turkey and Argentina experienced a banking and sovereign debt crisis. The latter holds the record for the largest default in history (USD 95bn in external debt). Contagion from the banking crisis in neighboring Argentina triggered the withdrawal of Argentine deposits in Uruguay and culminated in a financial crisis. Then we entered a tranquil period (2003-2006), which gave way to an enormous surge in global credit expansion. The result was the credit crisis that initially started in the US subprime mortgage market. After **Lehman's bankruptcy**, the financial crisis turned truly global. Of all the 22 advanced countries in our sample, only eight countries (Australia, Canada, Italy, Japan, New Zealand, Norway, Finland and Sweden) did not experience a banking crisis during the Great Recession.

Interestingly, none of the major emerging and developing countries in our sample, with the exception of Hungary and Russia, experienced a banking crisis in this period. The only sovereigns that defaulted were Ecuador (2008) and Jamaica (2010). Ecuador's default represented a problem of 'willingness-to-pay' more than 'ability-to-pay' as the government's decision to default was based on ideological and political grounds and was not related to immediate liquidity and solvency issues. Jamaica, on the other hand, defaulted due to a series of shocks, unsustainable government policies and a high debt burden.

Lessons to be drawn from history

From the history of financial crises we can draw two important conclusions. ***First, financial crises are very common phenomena and no region is immune.*** *Latin America has been the region with the highest number of default episodes (135) and Europe with 61 episodes remains a distant second. Meanwhile, Europe holds the number one position in banking crises (149 episodes) while Latin America with 68 episodes remains second. This is because the advanced countries, with their more 'mature' financial markets, have been more susceptible to banking crises (see figure 4).*

Figure 4: Banking and sovereign debt crises



Source: Reinhart (2010), Rabobank

To this end, it is very difficult to reconcile why market participants always suffer from what Reinhart and Rogoff (2009) call the 'this-time-is-different' syndrome – the belief that financial crises are things that happen to other countries at other times because the countries they invest in have the right policies and are built on sound fundamentals. Apparently, market participants always tend to believe that the lessons learnt during the past crises no longer hold in the present context. Let's not forget that public debt of all advanced countries was considered 'risk-free' before the eurozone debt crisis erupted in 2009. Ever since, investors started realising that sovereign risk, which was a non-issue after WWII, is still very relevant in the industrialised world.

Second, financial crises are usually bunched in temporal and regional clusters, which correspond to boom-bust cycles in international capital flows. *Lending booms amid surges in global capital mobility, therefore, serve as a useful early warning indicator for impending crises. As such, countries experiencing a large expansion in credit become highly vulnerable to financial crises. In specific, countries which posted relatively large current account deficits (i.e. were 'living beyond their means') faced severe financial crises during the Great Recession (e.g. Portugal, Greece, Spain, Ireland, Iceland, and the UK). Of course, many of the capital exporting countries (e.g. Switzerland, Germany and Austria) also suffered from a crisis because their financial institutions were heavily exposed to crisis-prone countries. So the relationship is not as straightforward as one would hope.*

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